In The
Supreme Court of the United States

October Term, 199[illegible]

Barclays Bank PLC,
Petitioner,
v.
Franchise Tax Board,
Respondent.

Colgate-Palmolive Company,
Petitioner,
v.
Franchise Tax Board,
Respondent.

On Writ of Certiorari to the Court of Appeal

QUESTION PRESENTED

Whether California's worldwide combined reporting method of determining the portion of the income of a unitary business attributable to its activities in California is constitutional under the foreign Commerce Clause and the Due Process Clause as applied to either a unitary group with a foreign parent (Barclays) or a unitary group with a domestic parent (Colgate-Palmolive).

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BRIEF OF THE COUNCIL OF STATE GOVERNMENTS, NATIONAL GOVERNORS' ASSOCIATION, U.S. CONFERENCE OF MAYORS, INTERNATIONAL CITY/COUNTY MANAGEMENT ASSOCIATION, NATIONAL LEAGUE OF CITIES, NATIONAL ASSOCIATION OF COUNTIES, AND NATIONAL CONFERENCE OF STATE LEGISLATURES AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

INTEREST OF THE *AMICI CURIAE*

Amici, organizations whose members include state, county, and municipal governments and officials throughout the United States, have a compelling interest in legal issues that affect state and local governments. Among the most important of such issues are those raised by federal limitations on state and local taxing authority. The petitions in these two cases raise constitutional challenges under the foreign Commerce Clause and the Due Process Clause to California's worldwide combined reporting method of taxation. With more than $2 billion in tax revenues at stake in California alone (Colg. Supp. Br. on Petition 4, Resp. Op. Cert. Colg. 15), this case presents a grave challenge to the existing tax schemes, revenue-raising powers, fiscal health and legislative discretion of state governments. *Amici* have a vital interest in seeing that this threat is turned back and the decisions below affirmed.[1]

STATEMENT

These cases involve the application of two methods of determining the portion of the income of a unitary multinational business attributable to its activities in a taxing jurisdiction. The two methods are worldwide combined reporting (WWCR), which is a type of formulary

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[1] The parties' letters of consent to the filing of this brief have been filed with the Clerk pursuant to Rule 37.3 of the Rules of this Court.

apportionment, and arm's length/separate accounting (AL/SA).

Under WWCR, as applied by California in the income years in question (1970-1973 and 1977), once a multinational business has been determined to be unitary (*i.e.*, operating as a single economic enterprise, even though divided into many subsidiaries or branches), the multinational is treated as one unit and the portion of its income attributable to California is determined based on a formula that takes into account the taxpayer's capital (property), labor (payroll), and the use of the market (sales) in California compared to the same factors on a worldwide basis. Pet. Br. Colg. 5-6.

Under AL/SA, instead of treating the unitary group as a single business, each separate subsidiary or branch of the multinational group is treated as if it were an independent enterprise dealing with all other units of the multinational group on an arm's length basis. *Id.* at 4-5.

Both petitioners have conceded that their operations in California (directly by the parent in the case of Colgate, and through a separate subsidiary (Barcal) and a branch of a U.K. corporation (BBI) in the case of Barclays) were part of single unitary businesses which included all other corporations in their controlled groups (approximately 220 corporations in the case of Barclays, and approximately 75 corporations in the case of Colgate). *Id.* at 4; Pet. Br. Barc. 3.

Barclays filed its income tax returns in California, with Barcal filing a separate accounting return and BBI filing a worldwide combined return for itself and all of its U.S. and foreign subsidiaries, including Barcal. Pet. Br. Barc. 11-12. Colgate filed its California return for the parent only, excluding its foreign subsidiaries. Pet. Br. Colg. 10. On audit, the California Franchise Tax Board determined (as petitioners here concede) that both petitioners constitute unitary businesses and therefore should file combined returns for their entire worldwide unitary groups. *Id.*; Pet. Br. Barc. 11. This change in method

of filing resulted in more of petitioners' income being attributed to California. Pet. Br. Colg. 10; Pet. Br. Barc. 11-12.

Petitioners now challenge the resulting increase in their tax burden on constitutional grounds, arguing that WWCR violates the foreign Commerce Clause and (in the case of Barclays) the Due Process Clause. Thus, petitioners argue that the Constitution mandates that California use AL/SA in taxing either a multinational unitary group with a foreign parent (Barclays) or a multinational unitary group with a U.S. parent (Colgate).

INTRODUCTION AND SUMMARY OF ARGUMENT

Petitioners' arguments depend on their portrayal of WWCR as a radical method used by California that is the antithesis of the arm's length method used by the federal government and the rest of the world. Pet. Br. Barc. 16; Pet. Br. Colg. 4-6. In reality, however, arm's length and WWCR approaches are not incompatible opposites, as petitioners would have this Court believe, but are part of a continuum. At a recent conference, both proponents and opponents of WWCR from the international community agreed that

> the arm's length principle and formulary apportionment should not be seen as polar extremes; rather, they should be viewed as part of a continuum of methods ranging from [comparable uncontrolled prices] to predetermined formulas. It is not clear where the arm's length principle ceases and formulary apportionment begins, and it is counterproductive and unimportant to attempt to apply labels to the methods.

Brian J. Arnold and Thomas E. McDonnell, *Report on the Invitational Conference on Transfer Pricing: The Allocation Of Income And Expenses Among Countries*, 61 Tax Notes 1377, 1381 (December 13, 1993).

Formulary methods similar to WWCR are commonly used in conjunction with the arm's length method by the

federal government and other countries. In recent decades, the federal income tax rules relating to the allocation of income in the international context have been evolving under the pressure of economic reality away from a pure arm's length approach based on comparable transactions, to a combination of comparable transactions and formulary approaches in the absence of comparables. *See e.g.*, 26 U.S.C. § 863(b); 26 C.F.R. § 1.863-3T(b). In this context, the United States is leading the world toward a new consensus that arm's length and formulary approaches are both parts of an acceptable continuum of methods.

The federal government's resort to formulary methods in conjunction with arm's length arises out of a central flaw in the arm's length approach which precludes its use in "pure" form. Indeed, Professor Langbein has commented that, because of these flaws, "arm's length, defined as the antithesis of fractional apportionment, not only is not a norm, it is not even meaningfully a concept." Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length,* 30 Tax Notes 625, 655 (February 17, 1986).

The arm's length method seeks to allocate the profits of each member (or branch) of a unitary group "as if those profits were earned by a separate enterprise." Barc. Petition 5. The obvious problem with this approach is that in the absence of actual comparable transactions between unrelated enterprises, it is often impossible to reconstruct what the hypothetical profits of the related enterprises should be. As this Court has recognized, the failure of separate geographic accounting to account for "factors of profitability [which] arise from the operation of the business as a whole" makes it "misleading to characterize the income of the business as having a single identifiable 'source.'" *Mobil Oil Corp. v. Commissioner of Taxes of Vt.*, 445 U.S. 425, 438-39 (1980).

This problem led the federal courts, in a series of cases beginning in the 1970s, to apply a variety of formulary methods to allocating the profits of the related enterprises. The federal government, which has long used formulary methods in combination with arm's length, formalized its use of this approach in 1993 with the issuance of temporary regulations applying a formulary approach in the absence of comparable arm's length transactions. *See* Intercompany Transfer Pricing Regulations Under Section 482, 58 Fed. Reg. 5310 (1993) (codified at 26 C.F.R. §§ 1.482-0T through 7T) ("temporary regulations").

Once the false dichotomy between WWCR and arm's length (as applied by the federal government) is exposed, petitioners' arguments crumble. It becomes clear that California's taxation method is permissible under this Court's foreign Commerce Clause [2] and Due Process Clause precedents.

1. As enunciated in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), and elaborated in *Container Corporation of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), the foreign Commerce Clause requires that a state tax scheme implicating international commerce meet two tests: first, it must not prevent the federal government from "'speaking with one voice' in international trade," *Container,* 463 U.S. at 193 (quoting *Japan Line,* 441 U.S. at 453), and, second, it must not result in international multiple taxation that can reasonably be eliminated by the State. *Container,* 463 U.S. at 189-90.

California's formulary method does not violate the "one voice" requirement of the foreign Commerce Clause because it is consistent with the method applied by the federal government itself in apportioning the income and deductions of corporations engaged in international commerce.

[2] The Franchise Tax Board argues that because Congress has acted to permit it to use WWCR, dormant Commerce Clause analysis is inapplicable to this case. *Amici* agree. However, to avoid duplicating respondent's extensive treatment of this issue, this brief will focus on demonstrating the constitutional validity of California's WWCR methodology, even assuming that dormant Commerce Clause analysis is applicable.

In fact, the federal government applies formulary approaches, in conjunction with the arm's length method, to U.S. branches of foreign corporations (including banks, such as BBI), to foreign corporations controlled by U.S. parents (such as Colgate and its subsidiaries), and to U.S. subsidiaries of foreign parents (such as Barcal); by international consensus, those formulary approaches do not violate the tax treaties entered into by the federal government. *See* Louis M. Kauder, *The Unspecific Federal Tax Policy of Arm's Length: A Comment On The Continuing Vitality of Formulary Apportionment At The Federal Level,* 60 Tax Notes 1147 (Aug. 29, 1993).

Moreover, in the context of allocating profits between a foreign corporation and its U.S. branch, the federal government has used a formulary approach virtually identical to California's since 1922. *See Intel Corp. and Consolidated Subsidiaries v. Comm'r,* 100 T.C. No. 39 (June 28, 1993), *reprinted in* BNA Daily Tax Report, June 29, 1993 at K-5, K-7–K-8, 1993 U.S. Tax Ct. LEXIS 38 (citing 42 Stat. 227, 244-45 (1921); Regs. 62, art. 327 (1922)). These methods are fully compatible with the arm's length approach and have achieved international acceptance. Thus, this Court should not hold that WWCR violates the "one voice" prong of the foreign Commerce Clause, since the federal government itself uses formulary methods akin to WWCR ubiquitously in its international tax régime.

2. In addition, as this Court held in *Container,* WWCR does not violate the multiple taxation prong of the foreign Commerce Clause because it does not pose more risk of multiple taxation than the arm's length method, as applied by the federal government. *See Container,* 463 U.S. at 191. Developments in the federal tax arena since 1983, when *Container* was decided, have dramatically demonstrated that "California would have trouble avoiding double taxation even if it adopted the 'arm's length' approach" as it is applied by the United States and interpreted by the courts under 26 U.S.C. § 482. *Container,* 463 U.S. at 192. In fact, the International Chamber of Commerce, in commenting on the recently issued temporary regulations implementing the federal approach to this issue under 26 U.S.C. § 482, has stated that the regulations "will inevitably lead to double taxation." Letter of International Chamber of Commerce of 4/22/93, ¶ 21, *reprinted in International Chamber of Commerce Attacks New Transfer Pricing Regs.,* Tax Notes Today, 93 TNT 113-24 (May 27, 1993).

3. California's WWCR does not violate the Due Process Clause because it is no more burdensome or arbitrary than analogous federal provisions, which have not been challenged on due process grounds. California does not impose a heavier burden on U.S. subsidiaries of foreign parents, such as Barcal, than is already imposed on domestic corporations that are 25 percent or more foreign-owned (under 26 U.S.C. § 6038A and the regulations thereunder) or for U.S. branches of foreign corporations, such as BBI (under 26 U.S.C. § 6038C). Nor are the standards used by California in applying WWCR any more vague or capricious than the standards used by the federal government under the corresponding provision of federal tax law, 26 U.S.C. § 482, which was first enacted in substantially its present form in 1928. Hence, WWCR cannot be invalidated on due process grounds without casting a heavy shadow over analogous, generally accepted provisions of federal tax law.

ARGUMENT

I. CALIFORNIA'S FORMULARY METHOD DOES NOT VIOLATE THE FOREIGN COMMERCE CLAUSE

Petitioners' contention that California's use of WWCR violates the foreign Commerce Clause is premised on two core arguments: first, that WWCR prevents the federal government from "'speaking with one voice' in international trade," and, second, that it results in international multiple taxation that can reasonably be eliminated by the use of arm's length. Each of these arguments is meritless.

Petitioners' one voice argument depends on their depiction of WWCR as an idiosyncratic tax system that is "separate and different" from, and "incompatible with," the "international standard" of arm's length. Pet. Br. Barc. 16. This reductionist portrayal is irreconcilable with reality. Formulary apportionment is not idiosyncratic and has been repeatedly upheld by this Court. *See, e.g., Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Mobil Oil*, 445 U.S. at 438-40; *Container*, 463 U.S. at 197. Equally important, formulary apportionment and arm's length are not, as petitioners would have this Court believe, polar opposites, but are part of a continuum. *See, e.g.*, Arnold & McDonnell, *Report on the Invitational Conference*, 61 Tax Notes at 1381. Indeed, as employed by the federal government, arm's length commonly uses formulary components. There is no basis for petitioners' assertion that California prevents the federal government from speaking with one voice, because the federal government uses formulary methods ubiquitously in its international tax regime.

Petitioners' multiple taxation argument is likewise unavailing. WWCR does not violate the multiple taxation prong of the foreign Commerce Clause because it does not pose more risk of multiple taxation than the arm's length method as applied by the federal government.

The errors in petitioners' analysis of these two issues flow from a common source. As *amici* show immediately below, the inherent limitations of the arm's length method as applied to multinational parents and subsidiaries routinely compel taxing authorities, including the United States, to use elements of formulary apportionment in conjunction with tax systems denominated "arm's length."

A. The Basic Theoretical Weaknesses Of The Arm's Length Approach, Recognized By This Court, Require Resort To Formulary Methods

In upholding the constitutional validity of formulary apportionment, the Court has repeatedly emphasized the theoretical failings inherent in the arm's length method.

In *Mobil Oil*, and again in *Container*, the Court explained that

> separate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required.

Mobil Oil, 445 U.S. at 438 (internal citation omitted), *quoted in Container*, 463 U.S. at 181; *see also Trinova Corp. v. Michigan Dept. of Treasury*, 498 U.S. 358, 378 (1991); *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 74 (1989). It is not possible to determine accurately the income of each component of a unitary business on a separate, geographic basis because, as the Court has observed, the underlying profit figures "are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." *Container*, 463 U.S. at 181; *see also* Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting With Formulary Apportionment*, 60 Tax Notes 1131, 1140-41 (August 23, 1993).[3]

"[S]licing a shadow," as the *Container* Court called the attempt to allocate the income of a unitary group geographically, 463 U.S. at 192, does not become any easier if the unitary group, as in this case, crosses national as well as state boundaries. A simple example illustrates the problem.

[3] The Court's reasoning defeats Barclays' argument (Pet. Br. Barc. 24) that formulary methods erroneously assume equal profitability of all portions of the unitary enterprise. Formulary methods are necessary precisely because there is no way of establishing accurate profit figures for each component of a unitary enterprise.

Suppose foreign parent (FP) manufactures a widget at a cost of 50 and sells it to domestic subsidiary (DS) which resells it for 100. If DS has marketing costs of 20, it would have a profit if it bought the widget for any price below 80, while FP would have a profit if it sold the widget for any price above 50. The interval, between 50 and 80, represents a potential profit continuum, and the related parties can split it in any way they wish and still each make a profit. In the absence of comparable transactions with unrelated taxpayers, it is virtually impossible to definitively allocate the profit of 30 to either party.

Ordinarily, one could attempt to split the profit based on the economic functions performed by the parties. In the context of a unitary group, however, there is an additional economic reality that complicates this task: Like any organization, unitary groups exist because of market and non-market advantages that are derived from their structure. *See, e.g.*, J. Hellerstein, *Federal Income Taxation of Multinationals*, 60 Tax Notes at 1135-36. Thus, even if one applies a market rate of return separately to each of the components of the unitary group, the result is less than the actual return of the organization as a whole. The synergistic interaction among the constituent parts of the organization results in a residual that cannot be assigned to any separate geographic component.[4]

Any rule that arbitrarily assigns this residual to a member of the group distorts economic reality, because there is no single correct arm's length result. *See* H.R. Rep. 426, 99th Cong., 1st Sess., 423-24 (1985) ("A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept

[4] If there is a large residual resulting from the advantages afforded by the group's unitary structure, that same residual drives competitors out of the market, making comparables even less likely to be found. *See* Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 Tax Notes 625, 654-55, 666-69 (February 17, 1986).

in the absence of comparables.") (footnotes omitted); David R. Tillinghast, *An American View of International Intercompany Pricing Problems, in* 1979 Conference Report: Report of the Proceedings of the Thirty-First Tax Conference 469, 476 (Canadian Tax Foundation 1980) (where comparable uncontrolled transactions do not exist, "the plain fact . . . is that there is no such thing as an arm's-length price"), *quoted in* J.A. 827 (trial testimony of Tillinghast as Barclays' expert witness).[5]

In a long series of cases since 1980, this problem has bedevilled the federal courts in their attempts to deal with transfer pricing issues under 26 U.S.C. § 482 in the absence of comparables. The result has been a series of stupendously long, fact-based opinions in which the courts eventually split the residual profit between the related parties based on some vague understanding of their respective functions. Judge Tannenwald recently described the dilemma the Tax Court faces in making allocation decisions in Section 482 cases as a task that is "most difficult to perform in light of the [c]ourt's inevitable lack of knowledge of the realities of the workings of a specific industry and of the business world generally, including particularly the international competitve atmosphere which those realities reflect." *Perkin-Elmer Corp. v. Comm'r*, T.C. Memo 1993-414, 1993 Tax Ct. Memo LEXIS 424 at 97-98 (Sept. 8, 1993). The court must nevertheless find "precise answers based on an imprecise record," *id.* at 98, usually by "find[ing] a middle ground—a task which

[5] *See also* J.A. 829 (expert testimony of Tillinghast) ("the basis on which [the] division of profit is made varies according to the judgment of the auditing agent and the IRS as to what would produce a reasonable approximation of what an arm's-length price would be"); Langbein, *The Unitary Method*, 30 Tax Notes at 654-55; Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 Tax Notes 339, 345-47 (July 20, 1992); U.S. General Accounting Office, GAO/GGD-92-89, *International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices* 60-62 (June 1992).

it has disavowed, in other contexts." *Id.* (citation omitted). "The task thus thrust upon us is," he wrote, "to put it mildly, frustrating." *Id.* at 96. *See also Hospital Corporation of America v. Comm'r,* 81 T.C. 520, 596-97, 601 (1983) (noting "the lengthy and inconclusive record" but finding "as a fact that 75 percent of the taxable income of LTD in 1973 was attributable to petitioner"); *Eli Lilly & Co. v. Comm'r,* 84 T.C. 996, 1191 (1985), *aff'd in part and rev'd in part,* 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Comm'r,* 88 T.C. 252, 376 (1987) ("best judgment" allocation of profit); *Sundstrand Corp. v. Comm'r,* 96 T.C. 226, 375 (1991) ("best estimate" by court of appropriate transfer price).[6]

Alternatively, to avoid such "rough justice" approximations, the federal courts have strained to find comparables where no economic comparables exist. Thus, in *United States Steel Corp. v. Comm'r,* 617 F.2d 942, 951 (2d Cir. 1980), the court of appeals found that a comparable existed despite widely different volume and risks, even though it realized that the result did not reflect "economic reality." A similar outcome was reached in *Bausch & Lomb, Inc. v. Comm'r,* 92 T.C. 525 (1989), *aff'd,* 933 F.2d 1084 (2d Cir. 1991). The Tax Court held that a comparable was valid despite the extremely different economic conditions existing between the related parties, and the court of appeals affirmed, reasoning that such differences "will always be the case when transactions between commonly controlled entities are compared to transactions between independent entities." 933 F.2d at 1091.

This burgeoning series of cases, which threatens to overwhelm the IRS and the Tax Court,[7] has led to increasing

[6] In the United States Claims Court (and its predecessor, the Court of Claims), the result has been one-sided victories for either side. *Compare E.I. Du Pont De Nemours & Co. v. United States,* 608 F.2d 445 (Ct. Cl. 1979), *cert. denied,* 445 U.S. 962 (1980), *with Merck & Co., Inc. v. United States,* 24 Cl. Ct. 73 (1991).

[7] "For the foreseeable future, transfer pricing litigation will place a heavy burden on the Service and the Tax Court." U.S.

criticism by the General Accounting Office and by Congress of AL/SA as applied at the federal level. *See* U.S. General Accounting Office, GGD-81-81, *IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations* (Sept. 30, 1981); H.R. Rep. 426, 99th Cong., 1st Sess. 423-25 (1985). The Conference Report on the 1986 Tax Reform Act instructed the IRS to conduct a study of the problem and to consider carefully "whether the existing regulations [implementing AL/SA] could be modified in any respect." H.R. Rep. 841, 99th Cong., 2d Sess. II-638 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4726. The result of these criticisms has been, first, a lengthy study by the Treasury Department recommending significant changes to AL/SA, Notice 88-123, 1988-2 C.B. 458 (the "White Paper"); second, proposed regulations with additional changes; and finally, in January 1993, the adoption of temporary regulations which significantly modify AL/SA at the federal level. 58 Fed. Reg. 5310 (1993) (codified at 26 C.F.R. § 1.482-0T through 7T). The most significant change in these temporary regulations is the express incorporation of formulary approaches into AL/SA in the absence of exact comparables. *See id.* at § 1.482-5T. As discussed immediately below, this is only the most recent development in the United States' long-standing use of formulary methods in conjunction with arm's length.

Treasury and IRS, *Report on the Application and Administration of Section 842* at 6-3 (April 9, 1992), *reprinted in* BNA Special Supplement 2, Report No. 70 at S-34 (April 10, 1992) (bound with BNA Daily Tax Report) (hereinafter "Treasury and IRS Report"); *cf.* GAO, *International Taxation* at 47 ("transfer pricing cases in general can be very burdensome, time-consuming, and expensive for the courts, IRS, and the companies involved").

In recent transfer pricing litigation under Section 482, Chevron produced 1.3 million pages of unlabelled documents to the IRS. *See Chevron Not Required to Label 1.3 Million Pages Turned Over To The IRS,* BNA Tax Management, Transfer Pricing Report, at 135-36 (July 7, 1993).

B. California's Method Does Not Violate The "One Voice" Requirement Of The Foreign Commerce Clause Because The Federal Government Uses Formulary Apportionment Itself In Conjunction With The Arm's Length Method

1. *The Federal Government Uses Formulary Apportionment In Conjunction With Arm's Length*

Petitioners' entire "one voice" argument is based on a false dichotomy between the "pure" AL/SA allegedly used by the federal government and other countries, and WWCR. *See, e.g.*, Pet. Br. Barc. 4-5, 16. However, the federal government—like other nations—does not adhere to pure AL/SA; instead, it commonly uses a combination of AL/SA and formulary approaches. Once this is recognized, the key assumption underlying petitioners' "one voice" argument crumbles. For why should California be forced to change its taxing method to comply with a single federal voice, when that voice itself uses methods similar to California's?

As this Court recognized in *Container*, AL/SA as applied by the United States is neither pure nor simple. It is a "qualified" arm's length approach under which every corporation is treated "for most—but decidedly not all—purposes as if it were an independent entity." 463 U.S. at 184-85. And there are "elaborate regulations" implementing the ability of the IRS to " 'distribute, apportion or allocate gross income' " among related taxpayers under 26 U.S.C. § 482. 463 U.S. at 190-91 (quoting 26 U.S.C. § 482).

Since *Container*, there have been significant developments in this area that have further modified AL/SA as applied by the federal government. These developments have led a group of experts—including senior officials of the U.S. Treasury, U.K. Inland Revenue, the Fiscal Affairs Division of the OECD, and the Japanese National Tax Administration—to conclude recently that "the arm's length principle and formulary apportionment should not be seen as polar extremes" and that "it is not clear where the arm's length principle ceases and formulary apportionment begins." Arnold and McDonnell, *Report on the Invitational Conference*, 61 Tax Notes at 1381 (December 13, 1993).

The easiest case to show that the federal government uses formulary approaches is the taxation of a U.S. branch of a foreign corporation, such as BBI. Since the Revenue Act of 1921, the Internal Revenue Code has included a provision like 26 U.S.C. § 863(b), which states:

> In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot definitely be allocated to some item of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or *formulas of general apportionment* prescribed by the Secretary.

26 U.S.C. § 863(b) (emphasis added).[8]

Regulations for the sale of personal property were promulgated under this section in 1922 and remain essentially unchanged today. *Intel*, 100 T.C. No. 39, BNA Daily Tax Report, June 29, 1993 at K-8 & n.4 (quoting Regs. 62, art. 327 (1922)). Operation of these regulations involves three examples, two of which are pertinent here: Example 1, which applies an arm's length methodology and Example 2, which employs a formulary approach. *See* 26 C.F.R. §§ 1.863-3(b)(2), Example 1 and 1.863-3T(b)(2), Example 2.[9]

Example 1 applies only if the taxpayer "regularly sells part of his output to wholly independent distributors or

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[8] *See* Revenue Act of 1921, ch. 136, 42 Stat. 227, 244-45 (1921). The history of 26 U.S.C. § 863(b) is described in *Intel Corp. v. Comm'r*, 100 T.C. No. 39, BNA Daily Tax Report, June 29, 1993 at K-7—K-8.

[9] Example 3 allows the taxpayer to apply "for permission to base the return upon the taxpayer's books of account." 26 C.F.R. § 1.863-3(b)(2), Example 3.

other selling concerns in such a way as to establish fairly an independent factory or production price," *i.e.*, if there is an independent arm's length transaction. *See* 26 C.F.R. § 1.863-3(b)(2), Example 1. Under rules promulgated by the IRS, it is exceedingly hard to find an "independent factory price" (IFP) under Example 1. The IFP must be derived from sales of the same manufacturer (not unrelated comparables) which are regular and substantial, must involve a wholly independent distributor, must not involve significant income-generating activity of the taxpayer other than manufacturing, and must reasonably reflect the income from manufacturing. Notice 89-10, 1989-1 C.B. 631-32.

In the many instances in which Example 1 is inapplicable, the IRS and the taxpayer generally must apply the method set forth in Example 2. Under Example 2, the annual taxable income attributable to sales of property produced abroad and sold in the United States is first split in half; then, the 50% allocated to manufacturing is apportioned between the U.S. and the foreign jurisdiction based on a property factor, and the 50% allocated to sales is apportioned based on a sales factor. 26 C.F.R. § 1.863-3T(b)(2), Example 2.[10] This method of apportionment is substantially similar to the formulary apportionment employed by California, except that payroll is not a factor and the federal sales factor is more open to manipulation because the location of sales is based on passage of title (a fact wholly within the taxpayer's control) and not on destination. *Compare* 26 C.F.R. § 1.863-3T(b)(2) and § 1.861-7(c) *with* Cal. Rev. & Tax Code § 25135.

Given the constraints on the use of Example 1, it is not surprising that the courts have repeatedly rejected IRS attempts to force taxpayers to use Example 1 rather than the formulary method of Example 2. *See, e.g., Phillips*,

[10] For an explanation of how Example 2 is applied, *see Phillips Petroleum Co. v. Comm'r*, 101 T.C. No. 6 (July 27, 1993), BNA Daily Tax Report, July 28, 1993 at K-5, 1993 U.S. Tax Ct. LEXIS 47.

101 T.C. No. 6, and *Intel*, 100 T.C. No. 39. Thus, for the substantial number of foreign unitary groups engaged in the manufacture of tangible property abroad and its sale in the U.S. through a branch, the federal government applies a formulary method highly similar to California's in the vast majority of cases.

Moreover, it should not be overlooked that the California business of BBI is not just a branch of a foreign corporation—it is a branch of a foreign bank. One of the most important activities of banks is accepting funds on deposit, and thus one of the most important determinants of their income is the allocation of interest expense. The federal government has recognized that because interest is fungible, the interest expense of branches must be apportioned based on a formula that takes into account the worldwide interest expense of the foreign taxpayer, and this method has been applied specifically to U.S. branches of foreign banks. Under 26 U.S.C. § 882(c), deductions allocated to foreign corporations engaged in a U.S. trade or business are apportioned and allocated under regulations prescribed by the Treasury. Under the relevant regulations, BBI's deductible interest expense in the U.S. is calculated based on a formula that compares BBI's U.S. assets to a ratio based on its worldwide assets and liabilities. 26 C.F.R. § 1.882-5(b). This formula is based on the same theoretical underpinnings as WWCR—that it is impossible to allocate income and expense among the parts of a unitary business based on pure AL/SA.

In the case of subsidiaries of a U.S. parent such as Colgate, the situation is slightly more complex. In this context the U.S. generally does not need to apply formulary methods because it has adopted a more extreme solution: Since 1962, the U.S. has considered it entirely legitimate to include the *entire* income of "controlled foreign corporations" such as Colgate's subsidiaries in the annual taxable income of their U.S. parent as a deemed dividend. *See* 26 U.S.C. §§ 951-960. This proposal, originally made by the Kennedy administration, was subsequently modified to include only certain types of income

in the U.S. parent's income currently, and to permit deferral of tax for other types. *See* S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), *reprinted in* 1962 U.S.C.C.A.N. 3304, 3381-83; Revenue Act of 1962, Pub. L. No. 87-834 § 12, 76 Stat. 960, 1006-27 (1962). But this privilege of deferral, granted for competitiveness reasons, has been steadily eroded and in the most recent tax act has been substantially limited, based on a formula that considers the foreign corporation's passive versus active assets. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 496-501 (August 10, 1993) (to be codified at 26 U.S.C § 956A) In any case, it has not been suggested that the U.S. is breaching an international consensus in currently taxing controlled foreign corporations, and there are recurrent proposals to end deferral altogether with no objection from abroad. *See, e.g.*, Foreign Income Tax Rationalization & Simplification Act of 1992, H.R. 5270, § 201, 102d Cong., 2d Sess. (1992). Clearly, it is much more drastic to allocate the entire income of *all* controlled foreign corporations to the U.S. than to apply WWCR to a domestic parent unitary group, such as Colgate.

Even under the classic arm's length situation, that of a U.S. subsidiary of a foreign parent (such as Barcal), the federal government applies a formulary approach in a large number of cases. This is the result of the reexamination of the regulations under 26 U.S.C. § 482 which was described above (at p. 13), which culminated in the current temporary regulations under that section.

As a preliminary matter, it is necessary to recognize that 26 U.S.C. § 482 itself, which has not been significantly changed since 1928, does not mandate the use of AL/SA or bar the use of WWCR: all it does is state that in the case of affiliated organizations, "the Secretary may distribute, apportion, or allocate income, deductions, credits, or allowances between or among such organizations" if necessary to clearly reflect their income. The actual apportionment can be done by pure AL/SA, pure WWCR, or any method in between.

In fact, under the current temporary regulations, if there is no comparable transaction the Secretary may base his § 482 adjustment on the "comparable profits method." This approach constructs a formula based on the profits of comparable, unrelated taxpayers and forces the related parties to adjust their transactions so that their profits fall within the comparable "arm's length" range of profits constructed by the formula. 26 C.F.R. § 1.482-5T.[11] This formula is used in a broad range of cases. Under a "best method rule" provided in the regulations, the formula will be applied when there is no exact comparable to be found, *i.e.*, in the majority of cases in which disputes arise between taxpayers and the IRS. *See* 26 C.F.R. § 1.482-1T(b)(2)(iii); James P. Fuller and Ernest F. Aud, Jr., *The New Temporary and Proposed Section 482 Regulations: A Wolf in Sheep's Clothing?*, 6 Tax Notes Int'l 525 (March 1, 1993).[12]

2. *The Federal Government's Use of Formulary Methods In Conjunction With Arm's Length Does Not Violate Its Treaty Obligations*

The federal government thus applies formulary methods, in conjunction with AL/SA, to U.S. branches of foreign corporations (BBI), to foreign subsidiaries of U.S. parents (Colgate), and to U.S. subsidiaries of foreign parents (Barcal). Why, therefore, has there not been an outcry of protest by foreign governments that the U.S. is violating its tax treaties? Because, contrary to petitioners' suggestions, *see* Pet. Br. Barc. 4-6; Pet. Br. Colg. 4-5, the use of formulary methods to apportion income

[11] The formula relies on "profit level indicators" that include ratios of profit to operating assets, costs (*e.g.*, payroll), and sales, *i.e.*, the same factors California uses. 26 C.F.R. § 1.482-5T(e). *See also* Proposed Regulation § 1.482-6, 58 Fed. Reg. 5310, 5311 (Jan. 21, 1993) (proposing a profit split method based on a formula that incorporates an assets factor).

[12] The use of such formulas in the new temporary and proposed regulations is but an implementation, delayed by over 30 years, of a congressional request to the Treasury Department to develop "formulas" for the application of 26 U.S.C. § 482. *See* H.R. Rep. 2508, 87th Cong., 2d Sess. 18-19 (1962).

and expenses on a worldwide basis, in conjunction with AL/SA, is fully compatible with the treaty obligations of the United States.[13]

First, let us look at the treaty rule on branches, or "permanent establishments," which is Article 7(2) of the U.S. Model Treaty. In *Container*, this Court cited the branch rule as "requir[ing] the Federal Government to adopt some form of 'arm's-length' analysis in taxing the domestic income of multinational enterprises." 463 U.S. at 196. The branch rule states:

> Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

U.S. Model Double Taxation Treaty, art. 7(2) (1981), *reprinted in Model Income Tax Treaties* (Kees van Raad ed., 1983); *cf.* Convention Between the United States and the United Kingdom for Avoidance of Double Taxation, art. 7(2), Dec. 31, 1975, U.S.-U.K., 31 U.S.T. 5670, 5675 (U.S.-U.K. Treaty).[14]

How, then, can the U.S. tax permanent establishments under formulary methods, as it does under 26 U.S.C. §§ 863(b) and 882? Three observations can be made in response. First, within the arm's length context established by Article 7(2), the treaty does not forbid the use of all formulary apportionment; it merely mandates the attribution to the branch of the same income that

[13] The following discussion of treaties is based on the analysis contained in Kauder, *The Unspecific Federal Tax Policy of Arm's Length*, 60 Tax Notes 1147.

[14] As discussed by respondent, these provisions govern only the taxing methodology of the federal government and have no applicability to the States. *See* Resp. Br. Barc. 16.

would have been attributed to it under AL/SA. Contrary to Barclays' assertions, it is quite possible for AL/SA and worldwide formulary apportionment to reach the same result—indeed, WWCR is intended to capture those synergies of a unitary business that would have been taken into account by a valid arm's length calculation. Two related businesses, if they were truly dealing with each other at arm's length, would take the synergies that result from their being part of a unitary enterprise into account in allocating the profit of the enterprise between them. Thus, if formulary methods reach the same or similar results as AL/SA in taxing the branch, this would be acceptable under Article 7(2).

Second, Article 7(3) of the U.S. Model Treaty, to which Article 7(2) is subject, expressly requires a "reasonable allocation" of expenses to the branch based on the expenses of the enterprise as a whole. U.S. Model Treaty, art. 7(3); U.S.-U.K. Treaty, art. 7(3), 31 U.S.T. at 5675-76. Thus, the formulary methods of allocating expenses under 26 C.F.R. § 1.882-5 are fully compatible with the U.S. treaty obligations, as the IRS has repeatedly stated. *See* Rev. Rul. 89-115, 1989-2 C.B. 130 (interpreting art. 7(3) of the U.S.-U.K. Treaty); Rev. Rul. 78-423, 1978-2 C.B. 194 (interpreting similar provision in U.S.-Japan Treaty); *see also* Rev. Rul. 85-7, 1985-1 C.B. 188 (same under 26 C.F.R.§ 1.882-5).

Finally, as noted above, formulary apportionment of branch income has been the established practice of the United States since 1922. It is well understood that such an established practice may continue under the AL/SA language of Article 7(2). Indeed, because formulary methods are commonly used by countries that are parties to treaties that require some form of AL/SA, the new OECD model treaty expressly provides:

> Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall pre-

> clude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

OECD Model (Income and Capital) Tax Treaty, Sept. 1, 1992, art. 7(4).[15] Thus, the United States can continue to tax branches of foreign corporations, such as BBI, based on formulary methods, without violating its treaty obligations.

Let us next look at the treaty rule regarding U.S. subsidiaries of foreign corporations, such as Barcal. Article 9(1) of the U.S.-U.K. treaty provides that "[w]here an enterprise of a Contracting State is related to another enterprise" and the relations between the two depart from arm's length, an adjustment to achieve arm's length conditions "may" be made, and in that case, the other state "shall make such adjustment as may be appropriate" to prevent double taxation resulting from the adjustment. U.S.-U.K. Treaty Art. 9(1) and 9(2), 31 U.S.T. at 5677; *cf.* U.S. Model Treaty Art. 9(1) and 9(2).

Louis M. Kauder suggests that Article 9(1) does not, by its terms, require the United States to do anything regarding the taxation of domestic corporations controlled by foreign parents. Kauder, *The Unspecific Federal Tax Policy of Arm's Length*, 60 Tax Notes at 1149-50. The

[15] For further evidence of the use of formulary in conjunction with arm's length by OECD member nations, *see* Treasury and IRS Report, Appendix E (Report of Agreed Discussions Between the Tax Administrations of France, Germany, the United Kingdom, and the United States) ¶ 3.5, BNA Special Supplement 2, Report No. 70 at S-41 ("In some industries and in some circumstances the use of a formula might be appropriate assuming that the formula attempted to approximate an arm's length result. One [such] area would be global trading . . . ."); *id.*, ¶ 3.6 ("Each one of us has expressed varying levels of support for using carefully tailored formulae in specific situations. The United States sees considerable advantages in this approach in particular cases. Germany and the United Kingdom have agreed to consider the use of such formulae in those cases.").

Senate Foreign Relations Committee, in its report on the Third Protocol of the US/UK Treaty, viewed Article 9(1) as "recogniz[ing] the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons." S. Exec. Rep. 5, 96th Cong., 1st Sess. 6 (1979). Thus, Article 9(1) certainly does not forbid the United States from using formulary apportionment, at least within the arm's length context.

In addition, as the *Container* Court pointed out, all of the U.S. treaties generally reserve the right to tax domestic corporations as if the treaty never came into effect. 463 U.S. at 196; *cf.* U.S. Model Treaty, art. 1(3). Thus, the United States could apply any formulary method to domestic subsidiaries of foreign parents, or to United States parents with foreign subsidiaries, without violating any treaty, as long as it is not considered to be taxing the foreign corporations included in the group. *See also* U.S. Model Treaty, art. 9(3) (permitting apportionment under language similar to 26 U.S.C. § 482).

Finally, the U.S.-U.K. treaty contains one unique provision not found in any other United States treaty—the notorious Article 9(4), 31 U.S.T. at 5677, which is the subject of much of the debate in this case. While the Church reservation prevented Article 9(4) from ever applying to California, *see* Resp. Br. Barc. 20-21, it does apply to the federal government, and prevents it from taking into acount the income of a related foreign enterprise in determining the tax liability of its domestic subsidiary. The inclusion of this Article makes it clear that Article 9(1), standing alone, does not prevent the U.S. from using formulary methods. Nor does Article 9(4) prevent the application of WWCR to U.K. subsidiaries of U.S. corporations, which are explicitly excluded from its scope. But even in the case of U.S. subsidiaries of U.K. corporations, the Senate Foreign Relations Committee report on Article 9(4) states that:

> The limitation in Article 9(4) applies only to cases where an allocation is made without regard to any application of the arm's-length standard. Of course, both countries may apply apportionment formulas, including formulas that take into account attributes of related entities, as a method of achieving an arm's-length price for a transaction between related entities. Moreover, apportionment formulas may be used as a method of apportioning income of related entities to the extent that it is established that they are not dealing on an arm's-length basis.

S. Exec. Rep. 5, 96th Cong., 1st Sess. 6 (1979).

Thus, even Article 9(4) does not prevent the federal government from using formulary methods, as long as they reach arm's length results, or it can be established that the related parties were not dealing at arm's length (as will frequently be the case).[16]

In sum, the "one voice" that petitioners contend California must adhere to employs formulary methods akin to California's ubiquitously in its international tax rules, in conjunction with AL/SA. This action by the federal government (and any further federal action along the same lines) does not violate any treaty obligations. And the international pressure on California, compared to the lack of foreign governmental protestations against the federal government, is a reflection of the relative political power of the United States and California, not of the merits of the issue.

[16] It has been reported that Barclays' own "advance pricing agreement" (APA) with the IRS and the U.K. taxing authorities, relating to a significant portion of its business, is based on taxing "the company's international affairs as one global business" and allocating the profits among jurisdictions based on an undisclosed "formulary methodology." *See IRS Grants Two APAs In Derivative Products Area,* Tax Notes Today, 92 TNT 96-1 (May 6, 1992) (discussing APAs for Barclays and Sumitomo). *See also* U.S. Treasury and IRS, *Joint Statement of Policy and Action Plan on International Tax Compliance* (Dec. 17, 1993), *reprinted in* BNA Daily Tax Report (Dec. 20, 1993), at L-2 (in negotiating APAs, the IRS "has made every effort to agree with the taxpayer on an appropriate methodology, and has applied, in appropriate cases, the methods specified in section 482, variations on those methods, and other methods, such as formulary apportionment").

This report suggests that Barclays acknowledges that formulary methods are appropriate for taxing its worldwide unitary business.

C. California's Formulary Method Does Not Pose More Risk Of Multiple Taxation Than The Arm's Length Method As Applied By The Federal Government

California's use of WWCR also satisfies the remaining prong of the foreign Commerce Clause test—it does not create a heightened risk of international multiple taxation. *See Japan Line*, 441 U.S. at 446-48; *Container*, 463 U.S. at 185. Colgate does not even contest this point, and Barclays' multiple taxation argument is inconsistent both with this Court's precedents and with subsequent developments in the arena of international taxation.

In *Container*, this Court addressed the multiple taxation prong of the foreign Commerce Clause test as applied to WWCR and held that WWCR does not violate this test because arm's length as applied by the federal government, may also lead to double taxation:

> A serious problem, however, is that even though most nations have adopted the 'arm's-length' approach in its general outlines, the precise rules under which they reallocate income among affiliated corporations often differ substantially, and whenever that difference exists, the possibility of double taxation also exists. Thus, even if California were to adopt some version of the 'arm's-length approach,' it could not eliminate the risk of double taxation of corporations subject to its franchise tax, and might in some cases end up subjecting those corporations to more serious double taxation than would occur under formula apportionment.

463 U.S. at 191 (footnotes omitted).

Developments since 1983, when *Container* was decided, have dramatically demonstrated the correctness of

these observations. The potential for double taxation under AL/SA results from the basic theoretical flaw of AL/SA—the fact that it does not provide a uniform or consistent way of making allocations where comparables are not available. *See* discussion at pages 8-12, *supra*. International double taxation is the likely outcome of AL/SA because one cannot expect foreign taxing authorities to respect allocations which the U.S. courts admit are based on a "best estimate" slicing of the shadow, or on economically inappropriate "comparables."

That multiple taxation is as likely under AL/SA (as applied by the federal government) as under WWCR is indicated by the reactions to the temporary regulations of foreign interested parties, many of whom are *amici* in this case in support of petitioners. They have vigorously objected to the most recent federal AL/SA plus formulary approach based on their contention that it will lead to international double taxation, and that the temporary regulations do not comport with the arm's length standard. Thus, the International Chamber of Commerce has stated unequivocally:

> We object to this new formulation both on general grounds, in view of the likely damaging consequences for international trade and investment . . . and, more specifically, because within the temporary regulations it is evidently designed to confer arm's length validity on a method—the comparable profits method—which in fact does not accord with the arm's length principle.

Letter of International Chamber of Commerce of 4/22/93, ¶ 11, *reprinted in International Chamber of Commerce Attacks New Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 113-24 (May 27, 1993). The International Chamber of Commerce went on to assert that the federal government's methodology "is contrary to the arm's length principle and will inevitably lead to double taxation. *Id.* at ¶ 21.[17]

[17] The Korean Ministry of Finance has made the same point by complaining that "the revised regulations are still not fully consistent with the internationally accepted arm's length standard." Letter of Rah-Yong Uhm of 8/9/93, Director General for Tax Affairs, Ministry of Finance, Republic of Korea, *reprinted in Korean Finance Ministry Comments on Transfer Pricing Regs.*, Tax Notes Today, 93 TNT 181-49 (Aug. 31, 1993). The Representative of German Industry and Trade has likewise stated that "[w]e continue to have fundamental, grave objections to the temporary intercompany transfer pricing regulations" on the grounds that they lead to incorrect results and "contradict[] the Arm's Length Standard." Letter of Christof S. Klitz of 7/19/93, *reprinted in German Industry Rep Takes Aim At Proposed Regs.*, Tax Notes Today, 93 TNT 163-64 (Aug. 5, 1993). Keidanren, the Japan Federation of Economic Organizations, asserts that the principal innovation of the temporary regulations "is not in accordance with the international rule of transfer pricing taxation . . . . [which] places great emphasis on an arm's length pricing system among entities." Letter of Tsunekazu Sakano of 7/13/93, ¶ 1, *reprinted in Keidanren Urges IRS to Take Another Look at Proposed Regs.*, Tax Notes Today, 93 TNT 158-24 (July 29, 1993).

It is thus clear that AL/SA, as applied by the federal government, is at least as likely to lead to international double taxation as WWCR. As the Court has already held, "it would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation." *Container*, 463 U.S. at 193 (citation omitted).

II. CALIFORNIA'S FORMULARY METHOD DOES NOT VIOLATE THE DUE PROCESS CLAUSE, AS IT IMPOSES NO HEAVIER BURDEN ON MULTINATIONAL CORPORATIONS THAN IS IMPOSED UNDER CURRENT FEDERAL LAW

Barclays' due process argument ignores the extensive requirements imposed on foreign-based multinationals under federal law, which have not been challenged on due process grounds. While California only needs worldwide payroll, asset, and sales data, and net worldwide income, the federal government needs a much broader range of information on the business of the foreign-based enterprise to implement AL/SA. In 1989 and

1990, Congress amended the Internal Revenue Code to authorize the Treasury to prescribe broad record keeping requirements for corporations that are 25% foreign owned, such as Barcal, and for foreign corporations engaged in a U.S. business, such as BBI, in both cases with penalties for noncompliance. *See* Pub. L. No. 101-239, § 7403, 103 Stat. 2358 (1989) (amending 26 U.S.C. § 6038A); Pub. L. No. 101-508, § 11315, 104 Stat. 1388-456 (1990) (adding 26 U.S.C. § 6038C).[18]

The following is just an illustrative list of the records required to be kept by foreign-owned corporations and foreign corporations under regulations promulgated to implement these sections in 1991: original entry books and transaction records relevant to transactions with the U.S. subsidiary; records from which "material profit and loss statements" can be constructed, including an explanation of any differences with United States generally accepted accounting principles (GAAP); "all documents relevant to establishing the appropriate price or rate for transactions" between the U.S. subsidiary and "any foreign related party"; all relevant "[f]oreign country and third party filings"; "[o]wnership and capital structure records"; and "[r]ecords of loans, services, and other nonsales transactions." 26 CFR § 1.6038A-3(c)(2).[19] The foreign party must deliver those documents to the Internal Revenue Service, or give the Service access to the records in the U.S., within 60 days of a request, and provide a translation of the records within 30 days of an IRS request. 26 CFR § 1.6038A-3(f). A substantial portion of the records must be created if they do not exist. 26 CFR § 1.6038A-3(c)(1).

Compared to these broad requirements, the burden imposed by California's rules, subject as they are to a "reasonably approximate" standard, pales to insignificance. Of course, "while Congress has plenary power to regulate commerce . . . it does not similarly have the power to authorize violations of the Due Process Clause." *Quill Corp. v. North Dakota*, 112 S. Ct. 1904, 1909 (1992). If this Court strikes down California's WWCR as unconstitutional on due process grounds, it jeopardizes the constitutionality of significant federal transfer pricing enforcement powers as well, which Congress has judged necessary to ensure that foreign-owned U.S. corporations pay their fair share of taxes.

[18] Until 1989, it was difficult for the IRS to obtain the required information from foreign entities. *See, e.g., U.S. v. Toyota Motor Corp.*, 561 F.Supp. 354 (C.D. Cal. 1983); *U.S. v. Toyota Motor Corp.*, 569 F.Supp. 1158 (C.D. Cal. 1983).

[19] *See also* the elaborate rules for determining what is a "material profit and loss statement" under 26 CFR § 1.6038A-3(c)(3)-(6).

The same analysis applies with even greater force to Barclays' argument that California's rules are too vague and arbitrary, despite being subject to court supervision. *See* Pet. Br. Barc. 47 (citing Cal. Admin. Code Tit. 18 § 25137-6).[20] It has been commonplace in litigation under 26 U.S.C. § 482 for courts to complain that in the absence of specific standards to guide them when there are no comparables, and given the extremely broad language of the statute, the IRS and the courts are required to reach decisions that are essentially arbitrary.[21] Perhaps the classic statement comes from a case decided in favor of the federal government, where the court's task was likened to "making bricks without straw." *Du Pont*, 608 F.2d at 461 (citation omitted) (Nichols, J. concurring). Judge Nichols went on to elaborate:

> [T]he Congressional request to write regulations to govern these § 482 reallocations is one sentence long: 'it is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority [§ 482] which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.' Clearly the result of our decision is that

[20] It is worth noting that California's Regulation 25137-6, the subject of Barclays' attack (*see* Pet. Br. Barc. 47-49), is derived from IRS regulations. *See* 26 C.F.R. § 1.964-1 (1992). If § 25137-6 is invalid, the federal regulation is similarly suspect.

[21] *See* the cases cited above in Part I.A; *see also* J.A. 829 (expert testimony of David R. Tillinghast).

> this has not been done . . . and it remains in the almost if not wholly unreviewable discretion of the Treasury, as it was when the suggestion was made.

Id. at 462 (internal citation omitted).

This lack of guidelines persisted until the temporary regulations were issued in 1993. However, the federal government's discretion under 26 U.S.C. § 482 has never been attacked on due process grounds, because (as in California) the courts were available to ensure that it was not applied in an arbitrary and capricious fashion, and in fact the courts have repeatedly struck down IRS assessments under 26 U.S.C. § 482.[22] The same analysis applies to California's analogous provisions. If this Court strikes down California's WWCR on due process grounds, it would cast a heavy shadow of doubt on the hundreds of cases that are currently pending under the federal law that preceded the issuance of the temporary regulations in 1993.

CONCLUSION

The judgments below should be affirmed.

Respectfully submitted,

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[22] *See, e.g.*, cases cited above in Part I.A. *Cf. Panhandle Oil Co. v. Mississippi ex rel. Knox*, 277 U.S. 218, 223 (1928) (Holmes, J., dissenting) ("The power to tax is not the power to destroy while this Court sits."), *overruled by Alabama v. King & Boozer*, 314 U.S. 1 (1941).